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STATE FOR USTR

E.O. 12958: N/A
TAGS: ECON EPET EFIN EAGR ETRD ENRG PGOV EG
SUBJECT: Egyptian Deputy Central Bank Governor discusses intervention and the economy

¶1. (SBU) Key Points:

--Deputy Central Bank (CBE) Governor Hisham Ramez said that the general nominal weakening of the Egyptian pound from July 2008 onward was primarily a function of market forces.

--After the pound hit a recent high of LE 5.7/$US in the exchange bureaus during the weekend of March 15, the CBE felt it had to signal to the market that trading for speculative purposes alone needed to be curtailed.

-- He shared the general optimism expressed by private analysts that inflation would continue to trend downwards, likely reaching single digits before June. He expected the real interest rate, which has been negative since December 2007, to become positive this summer.

--Since 80 percent of GDP is driven by consumption, Ramez argued that the government should be finding ways to stimulate consumption. He argued the 15 billion LE stimulus this fiscal year and 15 billion LE next year may not be enough.

Central Bank Intervention

¶2. (SBU) Deputy Central Bank of Egypt (CBE) Governor Hisham Ramez discussed the CBE's approach toward inflation and the exchange rate with Treasury Attache on April 1. Regarding the CBE's interventions in the foreign exchange market, Ramez stuck close to standard CBE talking points, noting that the CBE's policy is to allow supply and demand to dictate the exchange rate and that the CBE has no predetermined price for the pound in mind, and that the fundamentals of the country's economy will ultimately determine what the pound's value is. He said that the general nominal weakening of the currency from July 2008 until very recently was a function of market forces. He noted that it was a well known fact that Egypt's balance of payments situation was deteriorating and with it should come a natural weakening of the pound. However, in late February when Prime Minister Nazif made comments about the pound weakening, the CBE started to witness much more speculative activity in the market.

¶3. (SBU) After the pound hit LE5.7/$US in the exchange bureaus during the weekend of March 15, the CBE felt it had to signal to the market that trading for speculative purposes needed to be curtailed. He said all the CBE wanted was enough of an intervention to demonstrate to currency speculators that the CBE was willing to intervene to prevent disorderly depreciation. When asked what he thought of the press reporting on the intervention size, which varied from reports saying that the CBE spent $1 billion to "less than $100 million," he called the $1 billion reference "ridiculous" and pointed out what he had also pointed out to journalists - there were only $330 million in foreign currency purchases in the interbank market that day, so the CBE intervention had to be less than that. When journalists then glommed onto a figure of $100 million, he neither confirmed nor denied, but he told us it was less

than $100 million. He felt that the pound's stable trading around LE5.65/$US ever since the intervention shows that speculation has slowed or stopped and that the current price is a relatively accurate price for the currency. He noted that the Egyptian focus on the dollar-pound rate was unwarranted, and that the euro-pound rate was equally, if not more, important. The CBE's intention to focus increasingly on the euro-pound rate was also conveyed in last November's IMF Article IV consultations with the GOE on macroeconomic policy conditions. (Note: During the recent period in which the pound has nominally depreciated by about four percent against the dollar, the pound has appreciated against the euro. Compared with most world currencies, the pound has been very stable, and on a trade weighted basis, the pound has appreciated.)

Reserve Adequacy

¶4. (SBU) Ramez noted that the Central Bank still has large reserves and that "reserves are there for a purpose, so we will use them if we have to." That said, when referencing the $1 billion intervention figure from the press, he said that the CBE would not want to have to intervene that much, as it could indicate a more significant erosion of reserves. He said the end-March reserve level was $32.187 billion, which shows an $886 million decrease compared with end-February ($32.1 billion still represents 8 months of imports or 657% of short-term debt). The $866 million decrease is the largest monthly drop reported recently, and it throws into question how much the CBE really is intervening. Based on Ramez's end-March number, reserves have fallen $2.8 billion, or about 8%, since their peak in September 2008. In last November's IMF Article IV, the authorities indicated that they felt the reserves were adequate such that the balance of payments pressures could be met comfortably with a modest decline in CBE net reserves and more flexible exchange rate management. When asked about the composition of the reserves, he noted that only he and the Central Bank Governor know the details, but said that all the international reserves are in very conservative government paper, with none in corporate bonds or equities. He said that given recent low global interest rates, the CBE had been shortening the tenure of its investments.

¶5. (SBU) Comment: While the deterioration in reserves is not unexpected, and the levels remain healthy, the monthly reduction has become rather consistent and cannot continue forever. Currency traders may continue to watch CBE response to the weakened pound and could test the CBE's commitment to market principles. End comment.

Inflation

¶6. (SBU) Regarding inflation, he shared the general optimism expressed by private analysts that inflation would continue to decline, likely reaching single digits "before June". He expected the real interest rate (difference between the nominal interest rate and inflation), which has been negative since December 2007, to become positive this summer. He noted, however, that with the pound depreciating and monetary policy easing, he remains concerned about inflation ticking back up next year. Hence, he noted, the recent decision to bring rates down by only 50 basis points, rather than 100, showed the Central Bank's conservatism. Acknowledging the tremendous political pressure that the CBE has been under from nearly all parts of the government and the private sector to reduce rates more quickly, Ramez stuck to standard CBE talking points that price stability remains the overarching objective of the Central Bank, and with real interest rates negative, as they have been recently, there was no way to reduce rates more quickly. He is also concerned about the rising government deficit, which he argued could contribute to inflationary pressures. He also noted that the CBE intends to keep modernizing its monetary practices, with publication of the minutes of the Monetary Policy Committee meetings, one of the next important transparency improvements, expected within a year.

¶7. (SBU) Ramez noted that foreign investors left the Egyptian market very quickly in September-October 2008 at the peak of the worldwide financial crisis, as risk appetite dried up and investors had to cover their margins elsewhere. While losing $8-10 billion in such a short time was a shock to the system in Egypt, he noted that the

withdrawal of foreign investors was orderly, and Egypt took pride in the fact that when investors wanted to take their dollars home, they did not face any limitations or restrictions. He felt that this "positive" experience for investors will be remembered and will contribute to their desire to return when risk appetites return. He expected to start seeing a return of foreign investors later this year.

Banks

¶8. (SBU) Ramez noted his frustration that banks in Egypt "still have a free lunch," meaning that they can safely make much of their money from investing in nearly risk free Egyptian government treasury bills. Growth in lending and the leverage ratios at banks have barely moved in the past several years. Ramez reiterated that the CBE will not force banks to lend, but that they will try to find ways to make lending a more attractive business activity to banks. He also noted that the state-owned banks still have a ways to go in terms of modernizing and behaving on a commercial basis.

Crisis Reaction

¶9. (SBU) Regarding the slowdown in growth and the government's focus on trying to maintain high growth rates, he noted that interest rates will not contribute to economic recovery as much as fiscal spending will. Since 80% of GDP is driven by consumption, the government should be finding ways to stimulate that consumption, so he argued the LE 15 billion (US$2.65 billion) stimulus this fiscal year and LE 15 billion (US$2.65 billion)next year would not be enough. He expressed optimism in terms of the global response and the response in Egypt, noting that the U.S. had acted quickly and that international cooperation was unprecedented. He noted that the Finance Minister was under considerable pressure to simultaneously keep the deficit down while stimulating growth and sticking to the GOE reform agenda.
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